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To: Members of the Market Mechanisms Committee

From: Bill Beckmann

Date: April 3, 2000

Re: Market measures, competition and social entitlements

As we prepare for the second discussion tomorrow, I wanted to share a few thoughts. At the highest level the question before us is: can we find acceptable program reforms that would make the student aid program more effective and lower cost while helping more students afford the education of their choice? At the most basic level, since we already have 'the best program in the world', what can be done to make it more efficient using market mechanisms?

I think we need to clearly define 'What is the 'problem' we are trying to solve?'. Can we bound the 'constraints' against which we are attempting to optimize (e.g., what about school choice of lender/process, student choice, one student rate or many). Without these items understood, there is little objective basis to evaluate the merits of alternative proposals.

Following are some considerations as you review the proposals submitted for consideration:

1. **The current program works** (i.e., let's make sure the cure is better than the ills)

- The U.S. higher education system is solid
  - many argue it is a source of the economic boom due to productivity, services and tech strengths.
- Investment in a higher education is a great deal….75% higher income per household than without.
- A large and growing number/percentage of student participate in higher education
- Financial aid has been a primary enabler of access

This is not to say 'leave things alone'... the program is complex, and it is not clear it is 'lowest cost' or subsidies are distributed efficiently

2. Competition is robust (i.e., the 'market' is benefiting schools and students today)

- Market-based competition exists between FFELP and FDL. Within FFELP, lenders compete vigorously on the basis of school servicing, student servicing, technology, marketing, and more.
  - technology innovation is also a strong basis for competition: witness the growth of private loans, online applications and counseling, delivery systems (ELM, Laureate, NetWizard), etc.
- Price-based competition exists in the form of borrower benefits and discounts: witness guarantor discounting, national lender discounts, state-program *and even FDL fee discounting*
- Schools have their choice of programs, lenders, guarantors and loan delivery process
- Student have their choice of lender and dozens of supplemental loan programs
- Within FFELP classic competition patterns exist … consolidation of top provider share and vertical integration/alliances among guarantors, servicers, lenders and secondary markets.

To the degree competition exists today, above market returns are unsustainable. Therefore efforts to reduce returns (without volume or efficiency offsets) will reduce existing benefits and/or force the exit of less efficient providers.

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3. **Social entitlement considerations are the primary driver of program subsidies. Under a purely market-based program the benefits would not accrue this way**

- Loan guarantees with 98% reinsurance versus loan approvals based on proven credit history, income and collateral
  - Activity-based due diligence versus performance-based measures
- Student interest rate caps at a substantially lower level than other consumer debt instruments
- In-school rate subsidies for those with demonstrated (current) need … no private market parallel
- Below market interest rates (generally below secured consumer loans) with regulated maximum allowable rate, regardless of loan amount or credit history ... no private market parallel.

Each of these items serves a valuable purpose in encouraging reasonable cost, widely available credit, targeted at those with need. This goal is at odds, however, with a market approach that screens for and rewards those with demonstrated ability and willingness to pay. This is not to say there is not a better or market-based way to minimize the costs of these entitlements

4. **Previous efforts to apply auctions to student lending have not been successful due to the challenge of applying market measures (economic priorities) to a critical entitlement program (social priorities).**

- HEAL loan program
- Canadian Loan Program (auction of loss rates lenders would absorb) … now in bailout.
- U.K. Loan Program (gov. originates then sells …28% vx.11 US% subsidy, program not yet stable)
- No large scale, best practice model to emulate

With these thoughts as background I offer the following considerations:

1. Let's start with preserving the goal of affordable student access to education facilitated via school partners and competition via choice of service provider.
2. Let's debate, if needed, on whether the current market is a competitive. If we agree it is, this helps bound some of the discussion about what should change
3. Let's agree on the key success measures for a model … it can't be all items in the legislation equally (e.g., is number 1: access, choice, or lowest cost?)
4. Are there market-based means to reduce the cost or structure of program entitlements that minimize potential disruption (e.g., incrementally increasing credit reinsurance or reducing yield)? This would allow improved efficiencies while the implications are tested in the market.
5. Are there changes in the process that would produce efficiencies that could be put back into the program (e.g., performance-based diligence/claims vs. regulatory)?

I hope you weren't looking for the answer here! I look forward to our discussion tomorrow.